**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

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| Federal-State Joint Conference on Accounting Issues | ) | WC Docket No. 02-269 |
| 2000 Biennial Regulatory Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase II | ) | CC Docket No. 00-199 |
| Jurisdictional Separations Reform and Referral to the Federal-State Joint Board | ) | CC Docket No. 80-286 |
| Local Competition and Broadband Reporting | ) | CC Docket No. 99-301 |

# REPLY COMMENTS OF AT&T CORP.


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**REPLY COMMENTS OF AT&T CORP.**

Pursuant to the Commission's *Notice*,[1] AT&T Corp. submits these reply comments in response to comments submitted on the recommendations of the Federal-State Joint Conference on Accounting Issues ("Joint Conference")[2] that the Commission retain and strengthen its accounting regulations to ensure that the Commission and state regulatory agencies can effectively carry out their regulatory responsibilities, including their core responsibility to protect ratepayers from anticompetitive behavior by incumbent local exchange carriers ("LECs").

[1] Public Notice, *Federal-State Joint Conference On Accounting Issues*, WC Docket No. 02-269, *et al*., FCC 03-326 (rel. Dec. 23, 2003) ("*Notice*") (published in 68 Fed. Reg. 75478 (Dec. 31, 2003).

[2] Recommendation by Joint Conference, *Federal-State Joint Conference On Accounting Issues*, WC Docket No. 02-269, at 3 (Oct. 9, 2003) ("*Joint Conf. Recommendation*") (App. A to *Notice*).

## INTRODUCTION AND SUMMARY

AT&T's opening comments explained why the Commission should adopt each of the specific recommendations of the Joint Conference. The recommendations proposed modest changes to the number and types of regulatory accounts that dominant LECs were required to maintain, improvements in the affiliate transactions rules to close loopholes and provide more accurate valuations of such transactions, and minor revisions to the Commission's reporting requirements. Each of those recommendations was carefully considered over the course of the Joint Conference's year-long inquiry and represented the minimal change to the Commission's regulatory accounting and reporting requirements necessary to monitor the conduct of dominant LECs.

The Bells not only reject the moderate changes recommended by the Joint Conference, but would have the Commission eliminate *all* of its regulatory accounting rules and treat dominant incumbent local carriers that indisputably retain market power as though they have no incentive or ability to manipulate their books to harm captive ratepayers and would-be competitors. The Bells' comments offer some specific quibbles over the details of the recommendations; AT&T's opening comments and the reasoning of the Joint Conference's report fully answers these assertions. AT&T's reply comments therefore focus on the Bells' "big picture" arguments that, if accepted, would not only compel rejection of the specific recommendations of the Joint Conference but would upset the "balance" the Commission sought to achieve with its prior orders and would undermine *any* efforts to impose accounting and reporting safeguards to protect ratepayers.

The Bells argue, among other things, that: (i) no regulatory accounting or reporting requirement can be maintained or adopted if it is used only by state regulators, (ii) accounting and reporting requirements are outdated and unnecessary because price cap regulation eliminates all of the Bells' incentives to misallocate costs, and (iii) no specific rule should be maintained or adopted absent actual evidence that the Bells are presently engaged in conduct that the rule is intended to prohibit. None of the Bells' arguments have merit.

First, the Commission is not limited by the Act to maintaining or adopting only those regulatory and reporting requirements that can be linked directly to an explicit federal requirement. The Commission has traditionally worked in conjunction with the states to develop uniform accounting and recordkeeping rules, which has worked to the benefit of ratepayers as well as to regulators (who become expert in a single set of rules) and even to the carriers subject to the rules (who might otherwise be required to comply with different requirements in each state). In all events, the rules recommended by the Joint Conference, by and large, are needed to implement a federal purpose. Establishing rates for network elements or for resold services, for example, is a *federal* requirement that Congress enacted and requested the states to implement. The Commission should not deny the states the information that they need to fulfill that role – unless the Commission is eager to undertake those obligations itself. *See* 47 U.S.C. § 252(e)(5); *see also* Separate Statement of Commissioner Michael J. Copps ("Through participation in this group, it has become clear to me that it is vitally important the Commission ensure that States have the accounting information they need to do their jobs").

Second, price cap regulation is not a panacea that eliminates the need for all regulatory accounting rules and other safeguards designed to check the Bells' market power. The Commission has always recognized that none of its methods of regulation are, by themselves, sufficient for curbing Bell abuses and that each method employs a different means to achieve that goal. Price caps are aimed only at limiting the Bells' *incentives* to misallocate costs – not their *ability* to do so – and they do not perfectly achieve even that limited goal. In fact, and as explained below, there are numerous flaws in the price cap system, which means that the Bells retain powerful incentives to misallocate costs. Other safeguards, including the regulatory accounting and reporting rules that the Joint Conference addressed, are expressly designed to help federal and state regulators detect instances when the Bells seek to act on those incentives and harm competition and ratepayers of regulated services.

Third, even in the absence of actual evidence of Bell misconduct, the Commission is empowered to use its expertise and predictive judgments to adopt prophylactic rules that advance legitimate regulatory objectives, such as deterring the Bells from abusing their market power. Here, the Commission convened the Joint Conference in response to significant evidence of accounting irregularities – including some by one of the Bells opposing the Joint Conference's recommendations. The Commission clearly has a legitimate interest in detecting and deterring dominant carriers from engaging in abusive cost allocations and also in collecting information that advances competition. The Commission should therefore reject the Bells' claims that the Joint Conference's recommendations should not be adopted where the Joint Conference "provided no evidence" that the Bells have already engaged in the conduct the recommended rules are designed to prevent or detect. For the reasons explained by the Joint Conference and in AT&T's opening comments, each of the specific recommendations of the Joint Conference is directly related to a legitimate and necessary regulatory purpose, and each should be adopted. *See Cellco Partnership* v. *FCC*, No. 02-1262, slip op. at 11-12 (D.C. Cir. Feb. 13, 2004) ("*Cellco*") (rejecting the view that the Commission must eliminate any rule that it fails "provide evidence to demonstrate" is "*essential* in light of present market conditions;" rather, the Commission is empowered to adopt and to maintain rules "upon finding they that advance a legitimate regulatory objective"); *cf.*, *e.g.*, Verizon at 2-3; Qwest at 2-3, 6-9.

## I. THE COMMISSION SHOULD REJECT THE BELLS' CLAIMS THAT THE JOINT CONFERENCE'S RECOMMENDATIONS TO MODIFY THE REGULATORY ACCOUNTING RULES ARE UNNECESSARY AND BURDENSOME.

The Bells do not approve of a single specific recommendation by the Joint Conference that even modestly strengthens the Commission's regulatory accounting and reporting rules. And though each of the Bells (except for Qwest (*see* Qwest at 15)) offers some specific criticisms of the individual recommendations, it is apparent from the Bells' comments that they are not content with merely a flat rejection of some or even all of the work of the Joint Conference. Rather, the Bells are clear that, under the principles they would have the Commission adopt, *see, e.g.*, Qwest at 15; Verizon at 4, 22-24; SBC at 4-5; BellSouth at 2, *no* regulatory accounting safeguards of any kind would ever be appropriate.

But the Commission has not, either in its *Phase II Order* or elsewhere, ever intended to eviscerate the underlying basis for regulatory accounting safeguards. To the contrary, the Commission made clear in its *Phase II Order* that it must "attempt to strike an *appropriate balance* between the operations of a free market and a continuing need for some regulation." *Phase II Order* ¶ 2 (emphasis added); *id* ¶ 6. The Commission rejected an approach that would adopt "deregulation for its own sake," *id.*, and it recognized that regulatory accounting data that the incumbents record and then submit is used by the Commission and other regulators for a variety of critically important regulatory purposes that run to the core of the Commission's mission under the Act. Those purposes include determining appropriate methods for cost allocation and for jurisdictional separations, calculating proper levels of universal service support, and ensuring – even well *after* price caps were instituted – the Bells' interstate access charges are just and reasonable. *Id.* ¶¶ 10-12. And the Commission in the *Phase II Order* did not determine that its regulatory accounting rules should ignore states' needs for uniform accounts and data, but rather explicitly recognized that "the Commission and the states work together as partners," that "almost every state" relies on the Commission's accounting system, which thus has a "significant impact on state regulatory processes," and that "[u]niformity provides efficiency to the regulatory process for *both* federal and state regulators because regulators need only have expertise in one accounting system." *Id.* ¶¶ 20-22 (emphasis added).

The Joint Conference was able to employ this expertise and, over the course of a year, carefully re-examine some of the conclusions reached in the *Phase II Order*. Ultimately, as the Bells must admit, *see* Verizon at 3, the Joint Conference recommended the elimination of some requirements and the reinstatement and creation of other requirements. The Joint Conference thus still maintained the "appropriate balance" between deregulation and consumer protection that the Commission sought to achieve in the *Phase II Order*.[3]

The Bells, by contrast, seek to destroy any balance whatsoever and instead urge the Commission to reject each of the Joint Conference's recommendations that strengthen the regulatory accounting rules. Despite the sometimes lengthy nature of their objections to the specific Joint Conference recommendations, the Bells' arguments are, by and large, highly repetitive and can be boiled down to a few basic claims – each of which is demonstrably false.

*First*, the Bells claim that the Commission should no longer attempt to work cooperatively with the states as partners but should refuse to maintain or to adopt any regulatory

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[3] The moderate nature of the Joint Conference's recommendations shows the absurdity of the Bells' claims that, for example, the Joint Conference's report is "nothing more than a wish list of state regulators' accounting and financial reporting interests and desires." Qwest at ii. That claim hardly can explain why the two members of *this* Commission that served on the Joint Conference largely endorsed the report. *See* Separate Statement of Commissioner Michael J. Copps, at 1 ("I am heartened by the approach taken in the Joint Conference Recommendation"); Separate Statement of Commissioner Kevin J. Martin, at 1 (agreeing with the recommendations except for a "few aspects").

accounting and reporting requirements unless there is an explicit, "recent," and "compelling" "*federal*" need, no matter how important or necessary a requirement is for the states to fulfill their statutory or public interest obligations.[4] *Second*, the Bells claim that the institution of price cap regulation means that the need to use any accounting rules to regulate even the largest dominant carriers "has all but disappeared."[5] *Third*, the Bells argue that the Commission should not maintain or adopt any regulatory accounting rules based on its (or the states') expertise or on the view that carriers with market power are likely to engage in cost misallocation but must wait until there is actual "evidence of abuses" by the Bells.[6] *Fourth*, the Bells contend that the Commission should ignore all concerns of "accounting irregularities" and simply allow "Congress and the [SEC]" to address them.[7] *Fifth*, the Bells argue that there is no valid basis to create regulatory accounting or reporting rules that distinguish among Bell and independent telecommunications carriers or, in some cases, among any type of telecommunications carriers.[8]

If the Commission rejects the Bells' claims – as it certainly should – then it should adopt all of the specific recommendations of the Joint Conference, for the Bells offer virtually no other serious objections to those proposals. Moreover, the opening comments and the *Joint Conference Recommendations* fully explain why those proposals are critically important to protect captive ratepayers of the Bells' regulated services. And the Commission's choice here is

[4] *See* Verizon, Qwest, SBC and BellSouth, *passim*.

[5] *See, e.g.*, BellSouth Comments at 2; *id.* at 21 ("the need for rules to guard against cross-subsidization has vanished"); Verizon at 3, 13, 26; SBC at 7-8.

[6] *See, e.g.*, Verizon at 13; *id.* at 10-11, 13, 15, 16, 18, 19; SBC at 5, 7.

[7] *See, e.g.*, Verizon at 13; *id.* at 7, 22; BellSouth at 4, 10.

[8] *See, e.g.*, BellSouth at 13 ("there is no federal necessity for RBOC-only annual reporting"); *id.* at 3-4 (any valid federal reporting requirements must apply to "all providers"); *id.* at 6-8.

a simple one, because each of the Bells' remarkably extreme views, not surprisingly, has been rejected not only by the Commission, but, most fundamentally, by Congress.

### A. The Commission May Maintain Uniform Regulatory Accounting And Reporting Requirements.

The Bells' most basic and repeated objection to the Joint Conference recommendations – that the Commission has no authority to retain accounting rules that do not address a "federal" need – is meritless. *See Notice* ¶ 6; *Joint Conf. Recommendation* at 6-8. The statute unambiguously authorizes the Commission to establish a uniform system of accounts, and in all events, the purposes for retaining the particular challenged rules *are* federal purposes.

Congress gave the Commission the responsibility to adopt and maintain a national, *uniform* system of accounts in 47 U.S.C. § 220, to be used by both the Commission and the state commissions. Indeed, the Act expressly requires the Commission to "prescribe a uniform system of accounts" and further permits the Commission to "prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to the Act." 47 U.S.C. § 220(a). Moreover, the Act provides that "[t]he Commission, before prescribing any requirements as to accounts, records, or memoranda, shall notify each State commission having jurisdiction with respect to any carrier involved, and shall give reasonable opportunity to each such commission to present its views, and shall receive and consider such views and recommendations." *Id.* § 220(i). And Congress clearly intended that the Commission would ensure the accuracy and reliability of those accounts, because it expressly entrusted the Commission with the means of enforcing its accounting requirements. *Id.* § 220(c)-(g).

Congress placed the Commission in charge of establishing a uniform system of accounts, even as they relate to intrastate costs, precisely because the establishment of nationally uniform accounting is a uniquely *federal* function. Congress recognized that, for the dual federal-state system of regulation to work properly, there must be a single regulatory authority both to establish the costs attributable to regulated services and to allocate those costs to the interstate and intrastate jurisdictions. *See, e.g., Phase II Order* ¶ 10. The Commission is the only entity in a position to establish such a nationally uniform system of accounts that can ensure uniformity and accuracy of data and results across jurisdictions, both between the federal and state jurisdictions and among the state jurisdictions.[9]

The only alternative would be a hodgepodge of inconsistent accounting requirements imposed by state commissions, which would make uniformity of accounting impossible while simultaneously increasing the burden on both the state commissions and (ironically) the Bells themselves. In the absence of uniform federal rules, it would be impossible for the 50 state commissions to recreate a nationally uniform accounting system that would allow a state commission to examine the regionwide operations of an entire company (or make any other informed state-by-state comparisons). *See Phase II Order* ¶ 21 ("[u]niformity among states allows regulators or other interested parties to compare and benchmark the costs and rates of incumbent carriers operating in various states"). Such a hodgepodge of inconsistent requirements would also unquestionably be *more* costly for the ILECs. The commenters before the Joint Conference overwhelmingly agreed.[10] Nationally uniform accounting rules are thus a

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[9] WorldCom 2003 Comments at 6 ("[a]ny significant modifications to the accounting rules would have a direct impact on the states because (1) the states generally use the USOA for intrastate ratemaking; (2) the Part 32 accounts are the starting point for the separations process; (3) the Commission's cost allocation rules and affiliate transactions rules are applied pre-separations; and (4) the states often use Part 32 pricing data in UNE pricing cases").

[10] *See, e.g.*, Sprint 2003 Comments at 7 ("such action could also cause severe problems for ILECs that operate in multiple states. Today those ILECs have one set of reporting requirements and have the systems and people in place to comply with those requirements. If the states adopt their own requirements the likelihood is that the ILECs, instead of complying with one set of requirements, will have numerous, divergent requirements to follow, necessitating the creation of new systems and implementation of new training programs. Such additional regulatory burdens

(*continued . . .*)

quintessentially federal function, even when it is the state commissions that are relying on the data in the context of state regulatory proceedings.[11]

The Bells' extreme suggestion that the Commission nonetheless has no statutory *authority* to maintain a system of accounts for use by the states is frivolous. The Bells rely variously on 47 U.S.C. §§ 151, 154(i), 161, or 201(b) to read a "federal" limitation into the Commission's authority to adopt accounting rules. *See* Verizon at 4-5; SBC at 3; Qwest at 3; BellSouth at 9. These arguments ignore the fact that Section 220 expressly provides that the Commission has the responsibility to fashion a uniform system of accounts for both jurisdictions. Indeed, the Bells' position would not only read Section 220 out of the Act; it would fly in the face of decades of consistent practice.[12]

In all events, the Commission has recognized that the more detailed Class A system of accounts remains necessary for many explicitly federal purposes. For example, Class A accounting data is used in the administration of the Commission's universal service high-cost support mechanisms. *See Phase II Order* ¶ 45. It is still used in the Commission's price cap

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are antithetical to the Commission's stated purpose of providing regulatory relief"); Wisconsin 2003 Comments at 17 ("[t]he FCC will help minimize costs for the entire industry, a benefit to all telecommunications consumers, if it maintains a system of accounts that reflect the needs of both federal and state telecommunications industry regulators"); Florida 2003 Comments at 4 ("[e]stablishing requirements at an individual state level endangers this uniformity and consistency and could result in more cost burden to the ILECs rather than less").

[11] *See, e.g.*, North Carolina 2003 Comments at 3 ("[t]he FCC, as the only regulatory body possessing jurisdiction over all of the major ILECs, is uniquely positioned to prescribe national uniform accounting rules that permit all regulators, including the FCC, to adequately perform their oversight responsibilities").

[12] *Louisiana PSC* v. *FCC*, 476 U.S. 355 (1986), is not to the contrary. Contrary to Verizon's suggestion (at 7), it was undisputed in *Louisiana PSC* that federal accounting rules under § 220 properly extended to intrastate costs within the jurisdiction of state commissions. *See, e.g., id.* at 375-76. The Court held merely that the rate of depreciation was a ratemaking issue within the scope of 47 U.S.C. § 152(b), rather than an accounting issue within the scope of § 220.

regulation – *e.g.,* for exogenous cost adjustments and the evaluation of tariff revisions. *Phase II Order* ¶ 46. Detailed accounting costs are also indispensable for establishing rates for unbundled network elements, and the Commission has found that the absence of Class A accounting would "significantly compromise regulators' ability to implement the local competition mandates of the 1996 Act." *Phase II Order* ¶¶ 49-50.[13] The establishment of accurate UNE pricing that is subject to federal rules and standards is clearly a *federal* interest. Unless the Commission is prepared to conduct UNE pricing proceedings itself pursuant to § 252(e)(5), it should not eliminate regulatory accounting data that states need to implement this federal requirement. In addition, the Commission has found detailed accounting to be necessary for other unquestionably federal purposes, such as updating depreciation ranges, resolving disputes over pole attachment rates, and distinguishing between different types of investments in various regulatory contexts. *See Phase II Order* ¶¶ 47-48, 51-53. Indeed, detailed accounting data can prove necessary in many contexts; as AT&T noted in its Comments (at 7), the Commission relied on ARMIS data in rejecting Bell tariffs imposing massive "security" deposits from their access customers.[14]

The Bells also argue at length that federal accounting rules cannot be retained under § 11 unless there is a demonstrated federal "need," in the sense that the regulation must be indispensable or essential. *See* Qwest at 5-9; Verizon at 4-5. The Commission has rejected the ILECs' interpretation of § 11, and the D.C. Circuit has now affirmed the Commission's reading of the statute. *See Cellco*. As the D.C. Circuit held, the phrase "necessary in the public interest"

[13] *See* 47 U.S.C. §§ 251-52. *See also* WorldCom 2003 Comments at 1-2 ("in many instances the states are using regulatory accounts information to carry out their mandate under the federal Telecommunications Act").

[14] *See* Policy Statement, *Verizon Petition for Emergency Declaratory and Other Relief*, WC Docket No. 02-202, ¶¶ 18-21 (rel. December 23, 2002); *see* Worldcom 2003 Comments at 3.

in § 11 permits the Commission to retain rules as long as they "advance a legitimate regulatory interest"; they need not be indispensable. *See id.*, slip op at 12-13. As the Joint Conference explained, the rule changes it has proposed unquestionably meet that standard.

In this regard, the notion that the Commission's current accounting requirements represent a substantial burden on the ILECs is simply preposterous. The Bells' own study submitted in the Phase II proceeding, even if true, showed that the complete elimination of Class A accounting and switching to Class B accounting would save the LECs only $2 million annually. *See* Comments of USTA, CC Docket No. 00-199, at 6 (filed December 21, 2000). The reinstatement of the accounts that the Commission initially eliminated in the *Phase II Order* would, *a fortiori*, represent a far smaller burden on the Bells. As the record in the Phase II proceeding made clear, the Bells already maintain far more complex accounting data in their own accounting systems.[15] The Bells' claim that the Commission's accounting requirements place them at a competitive disadvantage, but they ignore that they alone have market power. Whatever costs the Commission's accounting requirements impose are clearly outweighed by the Bells' other advantages. Complete repeal of the Commission's regulatory accounting requirements would serve only to shield the Bells from regulatory scrutiny, and as long as they maintain market power, such radical repeal would be entirely inappropriate.[16]

[15] See AT&T Reply Comments, CC Docket No. 00-199, at 8, January 30, 2001; *see also* NASUCA 2003 Comments at 3 ("the detriment of losing access to the information outweighs any benefit resulting from reducing the regulatory burden on the carriers. The carriers already have forms established to capture this information, as a good business practice, information reported, as well as that previously reported, would be compiled regardless of reporting requirements. Therefore, the benefit to the carriers from eliminating reporting requirements is not significantly reduced expenses associated with reporting the data. Rather the benefits are the ability to insulate themselves from accountability, including fines, and from the threat of negative reactions that would result from false reporting").

[16] *See, e.g.*, WorldCom 2003 Comments at 5 ("the core requirements of Part 32 and Part 64 be retained until an ILEC has been declared nondominant for all services. As long as an ILEC

(*continued . . .*)

### B. Price Cap Regulation Does Not Eliminate The Bells' Incentives To Misallocate Costs And The Commission's Regulatory Accounting Rules Therefore Remain Vitally Important Safeguards

The second argument that underlies virtually all of the Bells' objections to the Joint Conference's recommendations is that the Commission's regulatory rules are nothing more than a "vestige" that has been mistakenly retained even after price caps replaced rate-of-return regulations for the Bells. *E.g.*, BellSouth at 21; Verizon at 3, 13, 26; SBC at 7-8. According to the Bells, price cap regulation entirely "severs" any link between the costs and prices of regulated services, and thus eliminates any incentive the Bells have to misallocate costs and harm ratepayers of their captive services. BellSouth at 2; SBC at 7-8. These claims are simply not supported by fact.

As an initial matter, regulatory accounting rules are by no means a vestige of rate-of-return regulation, but in fact serve as one of many complementary safeguards (one of which is price caps) that remain vital to assist state and federal regulators in their efforts to ensure that the Bells do not run afoul of the fundamental principle – which has been recognized "[s]ince the advent of . . . competition in the mid-1960s" – that "carriers with market power in regulated services" have significant incentives "to recover the costs of competitive services from subscribers to less competitive, regulated services by misallocating the costs of their competitive

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(. . . *continued*)
remains dominant in the provision of interstate services, i.e., possesses market power, the accounting rules remain necessary for ensuring that rates remain just and reasonable. Among other things, the Part 32 USOA restrains an incumbent LEC's ability to charge monopoly prices because it provides ratepayers with information that can be used to pursue a complaint against unjust and unreasonable rates, or to challenge tariff filings. . . . Furthermore, the Joint Conference should recommend that the Commission not eliminate the core requirements of Part 32 or Part 64 unless it has first determined that section 251(c) and 271 of the Act have been fully implemented").

services."[17] In the 1996 Act, Congress fully endorsed this principle, and put in place explicit safeguards requiring the Commission to take steps to ensure that ratepayers are not harmed by cost misallocation during the period before robust, and lasting local competition truly dissipates the Bells' market power and any incentive to misallocate costs. For example, in section 254(k), Congress directed the Commission to establish "any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services." *Id.* Congress established this requirement even though price caps had been applied to the Bells' services for years – demonstrating that Congress rejected the view that price caps alone could eliminate incentives to misallocate costs.[18]

More fundamentally, price caps do *not* entirely sever the link between costs and prices, and thus the Bells still have incentives to misallocate costs – and the Commission's regulatory accounting rules and Joint Conference's recommendations are expressly designed to detect and

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[17] *Implementation of Section 254(k)*, 12 FCC Rcd. 6415, ¶¶ 2, 6 (1997) ("*Section 254(k) Order*"); *see also Regulatory Treatment of LEC Provision of Interexchange Services*, 12 FCC Rcd. 15756, ¶ 134 (1997) ("as long as the B[ells] retain control of local bottleneck facilities, they could potentially engage in improper cost allocation, discrimination, and other anticompetitive conduct"); *Implementation of the Non-Accounting Safeguards of Sections 271 and 272*, 11 FCC Rcd. 21905, ¶¶ 9-13 (1996) ("*Non-Accounting Safeguards Order*"); *see also Bell Operating Company Provision of Out-of-Region Interstate, Interexchange Services*, 11 FCC Rcd. 18564, ¶ 39 (1996); *Accounting Safeguards Under The Telecommunications Act of 1996*, 11 FCC Rcd. 17539, ¶ 58 (1996) ("*Accounting Safeguards Order*"); *Southwestern Bell Corp.* v. *FCC*, 896 F.2d 1378, 1382 (D.C. Cir. 1990) (the Commission's joint cost rules are a reasonable "response to systematic incentives to shift costs"); *BellSouth* v. *FCC*, 144 F.3d 58, 67 (D.C. Cir. 1998) (it is well-recognized that the Bells "enjoy a materially greater opportunity to shift costs from their [competitive] pursuits to their rate-regulated local exchange ventures").

[18] Congress also established accounting safeguards in numerous other sections of the Act. *See* 47 U.S.C. §§ 260, 271-76; *see generally Accounting Safeguards Order*. If the Bells were correct that price caps were sufficient to eliminate the "need for rules to guard against cross-subsidization," Congress would not have needed to enact any of these requirements.

deter such anticompetitive cost shifting. As AT&T and others have previously demonstrated in response to the Bells' claims in various proceedings that price caps act as a panacea to any and all risks of anticompetitive conduct, there are numerous reasons why, despite use of price caps to regulate interstate services, the Bells would benefit by inflating the costs of their regulated services and understating the costs of services that face some measure of competition.[19] It is simply not true that price cap regulation eliminates all benefits that the Bells could achieve by misallocating costs. As the Supreme Court concluded in 2002, "price caps do not eliminate gamesmanship" primarily because price caps are "simply . . . a rate-based offset" that, like rate-of-return regulation, still provides "monopolies too great an advantage." *Verizon Communications Inc.* v. *FCC*, 535 U.S. 467, 487-88 (2002).

First, as the Bells must concede, many states regulate prices for intrastate services using either rate-of-return regulation or forms of price cap regulation containing sharing mechanisms that in the long run do create direct links between prices and costs. As a result, the Bells will gain by misallocating costs to less competitive services so as to gain relief from regulators. The Commission has for this very reason previously rejected the Bells' arguments that price caps make it unnecessary to allocate costs between regulated and nonregulated services.[20]

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[19] *See, e.g,* AT&T Reply Comments, at 24-29, WC Docket No. 03-173 (Jan. 30, 2004) & Reply Decl. of Lee Selwyn ¶¶ 5-29 ("Selwyn TELRIC Reply Decl."); *see also* Letter of David Lawson, counsel for AT&T, to Marlene H. Dortch, FCC, at 3-4, WC Docket Nos. 02-33 (July 31, 2003); Letter of Frank Simone, AT&T, to Marlene H. Dortch, FCC, 5-6 & n.10, WC Docket Nos. 02-33 and 01-337 (Oct. 2, 2003); Letter of Gil M. Strobel, counsel to MCI, to Marlene Dortch, FCC, WC Docket No. 02-112, CC Docket No. 00-175 (Feb. 9, 2004).

[20] *See Accounting Safeguards Order* ¶ 271 ("Moreover, because these incumbent local exchange carriers' intrastate services may be subject to cost-of-service regulation or to a form of price cap regulation that involves potential sharing obligations or periodic earnings reviews, the incumbent local exchange carriers may still have an incentive to assign a disproportionate share of costs to regulated accounts").

Second, even if such explicit sharing mechanisms are eliminated, price caps – both at the state and federal level – are based upon indices and various productivity targets. As Dr. Selwyn explained in the ongoing TELRIC proceeding, the Bells have incentives to misallocate costs so as to make their earnings appear reduced and obtain regulatory changes in the price cap system. Selwyn TELRIC Reply Decl. ¶¶ 11-12; *see* Kenneth Train, *Optimal Regulation* 327 (1991) (under price cap regulation, a firm will have an incentive to "waste so as to convince the regulator to allow a higher cap"). In fact, Dr. Selwyn reports that under most price cap plans, an incumbent's "failure to achieve a particular productivity target has in virtually every instance been rewarded by reducing the target itself." Selwyn TELRIC Reply Decl. ¶ 11; *see id.* ¶¶ 18-22 (discussing specific examples in which Bells urged regulators (often successfully) to reduce and/or eliminate productivity targets).[21] These incentives exist both at the state and the federal level, particularly since the CALLS plan is due to expire soon and the Commission will be re-examining the Bells' access prices. Further, given the frequency with which incumbents' productivity targets have in fact been adjusted, it is by no means speculative to conclude that the Bells will misallocate costs to achieve regulatory relief.

Third, the Bells retain significant incentives to misallocate costs to inflate the prices their local service competitors pay for access to unbundled network elements. Even though the Act and Commission's rules require that UNE rates be based on forward-looking costs, as a practical

[21] *See also Joint Conf. Recommendations* at 24 (a dominant local carrier can benefit from cost misallocation by "making its regulated earnings appear as low as possible, such as when it is pursuing a takings claim, seeking regulatory relief based on allegedly depressed earnings, or is subject to a profit-sharing requirement"). This is no academic point, because Verizon recently filed a petition for mandamus claiming that rates approved by the Commission staff violate the Takings Clause. Verizon Virginia Inc.'s Petition For A Writ Of Mandamus, No. 04-1043, (filed Feb. 4, 2004) ("Verizon Mandamus Petition"). That claim was based on costs that Verizon extracted using the Commission's ARMIS data. *Id.* at 4.

matter, many of the cost models that are used to determine forward-looking costs rely as a starting point on the Bell-supplied data on current costs that are reported after the application of the Commission's cost allocation rules, a point the Bells concede.[22] By manipulating that data and improperly including the costs of nonregulated services in regulated services, the Bells could raise their rivals' costs by unfairly inflating UNE prices.[23] If the Commission were to apply the Bells' logic and eviscerate, or even eliminate, its regulatory accounting and cost allocation rules, it would be far more difficult for state commissions to serve the federal interest in setting UNE prices that properly reflect only the forward-looking cost of the element, and that do not include the costs (including an excessive share of joint and common costs) of any nonregulated services.

Fourth, as Dr. Selwyn recently explained, the Bells are able to game the price cap system because many so-called "competitive" services have been removed from price cap regulation, even though the Bells face little or no competition that in fact constrains their ability to raise prices. *See* Selwyn TELRIC Reply Decl. ¶¶ 13-16. In these circumstances, the Bells are able to raise prices for the services removed from price caps and then to shift the joint and common costs to the remaining price-capped services and away from non-price-capped services, generating excessive earnings for those services. *Id.* ¶ 15.

[22] *See* BellSouth at 25 n.59; *see also* Verizon Mandamus Petition at 4 (in determining its view of appropriate UNE rates, "Verizon's starting point for the calculation of its actual investment and operating costs is the FCC's standard accounting format, known as ARMIS").

[23] And of course, in the Commission's ongoing proceeding regarding its TELRIC rules, the Bells have vigorously contended that UNE rates should be determined through the use of their "actual costs." If that were permitted, then separating the costs of all nonregulated services, including broadband if the Commission were to deem it nonregulated, would be absolutely necessary to prevent competitors from paying UNE rates that, in effect, subsidize the costs of the Bells' broadband services.

Because the price cap system contains inherent imperfections, the Bells still retain significant incentives to inflate the costs of regulated services even if their prices are not generally determined by rate-of-return regulation. Accordingly, the Commission's regulatory accounting rules, which are aimed at reducing the Bells' abilities to act on their incentives to misallocate costs, continue to serve an important purpose by limiting cost misallocation and "ensuring that ratepayers share in any efficiencies generated from joint use of the network by nonregulated activities." *Section 254(k) Order* ¶¶ 3, 6.

### C. Congress Explicitly Charged The Commission To Adopt Prophylactic Rules That Would Ensure Proper Cost Allocations, And Did Not Require That The Commission Act Only In Response To Actual Evidence Of Abuse Or That It Defer To Other Agencies.

The Bells also urge the Commission to reject specific recommendations to improve the regulatory accounting rules – including proposals to strengthen affiliate transaction rules, to eliminate the centralized service exception that creates a gaping loophole in those rules, and to eliminate broad discretion that the Bells could abuse to value affiliate transactions improperly – on the grounds that the Joint Conference does not make any "showing[s] of abuse" by the Bells with respect to these rules. Verizon at 16; *id.* at 10-11, 13, 15, 16, 18, 19; SBC at 5, 7. There is clearly no validity to this argument, and the Commission should not reject the Joint Conference's recommendation and refuse to maintain rules that protect competition and ratepayers on the grounds that such rules are not necessary unless they respond directly to evidence of BOC abuses.

Indeed, the Bells made a nearly identical argument when the Commission first adopted its cost allocation and affiliate transaction rules, and the Court of Appeals had no difficulty rejecting it. Thus, the Bells – although they admitted that "affiliate transactions call for 'heightened regulatory scrutiny'" – contended that the Commission's rules were not narrowly tailored enough and that other measures would be adequate to address the risks. *See Southwestern Bell Corp.*, 896 F.2d at 1381. The Court of Appeals promptly rejected that claim, finding that "[e]ven a cursory glance at the regulatory history of telephone companies . . . exposes the fallacy of this premise." *Id.* Specifically, the Commission was empowered, "[b]ased on its past experience in regulating intracompany asset transfers and the complexity of these transactions," to conclude that its "accounting rules were *necessary* to brake the carriers' *potential* for abuse." *Id.* (emphasis added) As this decision makes clear, the Commission can and should design "prophylactic rule[s]" to respond to "systematic incentives to shift costs" and need not wait until the actual abuses occur. *Id.* And, as *Cellco* establishes, the Commission is not held to any higher standard – as the Bells claim (*e.g.*, Verizon at 2-3; Qwest at 2-3, 6-9) – when it is determining whether to retain existing rules. *See Cellco*, slip op. at 11-13. Indeed, the very purpose of the regulatory accounting rules is not merely to detect misallocation, but also from deterring such abuses from occurring in the first instance.

Further, as discussed above, Congress in the 1996 Act and specifically in § 254(k) only re-confirmed the necessity for the Commission to adopt "cost allocation rules, accounting safeguards, and guidelines" that will "ensure" that basic regulated services are not used to subsidize other Bell-provided services. Thus, nothing in the Act signals that the Commission should, in the period when the Bells retain market power, eliminate prophylactic rules and instead rely on *post hoc* remedies like the complaint process.[24] The recommendations of the Joint Conference represent the considered judgment of expert federal and state regulators on what changes to the regulatory accounting regime are "necessary" to "ensure" the Bells engage

[24] *Cf. Time Warner Entertainment Co., L.P.* v. *U.S.*, 211 F.3d 1313, 1322-23 (D.C. Cir. 2000) ("a prophylactic, structural limitation is not rendered unnecessary merely because preexisting statutes impose behavioral norms and *ex post* remedies").

in proper cost allocation, as Congress intended (§ 254(k)). The Commission should not reject those views on the grounds that it must wait for "smoking gun" evidence that the Bells are in fact engaging in illegal cross-subsidies or other anticompetitive abuses.

In all events, there is evidence of accounting abuses that should spur the Commission to adopt the Joint Conference recommendations. Indeed, the Joint Conference was convened precisely because there was evidence of numerous actual accounting abuses. The Bells contend that these abuses cannot, after all, "be a basis for continued or increased regulation under Part 32." BellSouth at 10. The Bells would instead have the Commission ignore this record of actual abuses and allow "Congress and the Securities and Exchange Commission" to handle actual abuses. Verizon at 13; *id.* at 7, 22; BellSouth at 4, 10. This is patently inconsistent with the Commission's mission. To be sure, there are no grounds for this Commission to institute rules on insider trading, financial accounting, and other matters squarely within the SEC's jurisdiction. But to contend, as Verizon does, that regulatory accounting rules that apply to dominant carriers "have *no* potential value" (Verizon at 7 (emphasis in original)) to detect and, more importantly, to prevent abuses, irregularities, and other accounting scandals is absurd. The Commission – and not the SEC – has squarely been charged by Congress to monitor particularly those telecommunications carriers with market power and their ability to use it to engage in accounting abuses. The regulatory accounting rules remain vital for the Commission to fulfill that role.

Because the Commission has a special role in regulating carriers with market power, the Commission cannot and should not eliminate its regulatory accounting rules and rely solely on GAAP, as the Bells contend. *E.g*, Verizon at 22. GAAP provides valuable financial accounting data, but it is not detailed and disaggregated to the level that is necessary for the Commission to ensure that carriers with market power do not engage in improper cost allocation that could affect services that the Commission and the states are charged with regulating, such as universal service, access charges, and rates for resold services and unbundled network elements. *See Phase II Order* ¶¶ 10-12; Separate Statement of Commissioner Michael J. Copps, at 1 ("Both the States and the Commission use reported data to develop an understanding of the plant, revenue, and expenses of carriers and to enable comparisons of companies over time. States also use it to develop prices for network elements, develop prices for resold services and conduct ratemaking proceedings").

The recommendations of the Joint Conference are the minimum and moderate requirements necessary for the Commission and the states to perform these duties. The Commission should not reject those recommendations and, in doing so, adopt the Bells' arguments that the Commission and states may abdicate to other agencies their fundamental responsibilities.

### D. Congress Clearly Intended That The Commission Monitor Affiliate Transactions.

With respect to the recommendations of the Joint Conference on affiliate transactions, including rules that would close loopholes that the Bells could employ to evade those rules (as they would plainly like to do), the Bells respond that these rules have been "forced" onto them and are simply "outdated." *E.g.*, BellSouth at 20. This blatantly mischaracterizes the Commission's affiliate transaction rules and the recommendations of the Joint Conference. To begin with, these rules have not been forced on the Bells. Rather, the Bells have consistently sought to enter nonregulated lines of business – and when they choose to do so while they retain market power over regulated services, the Bells' choice to offer these nonregulated services necessarily implicates the "fundamental postulate" underlying modern telecommunications law –

that they will use their market power over the regulated services to harm competition in the nonregulated markets and cause ratepayers for regulated services to pay excessive rates. And those harms have always been present even when the Bells choose to provide (or are required to provide) the nonregulated services through a separate affiliate. The Bells' suggestion that the Commission or the states "force" such regulation on the Bells is nonsense.

In this regard, when Congress determined in the 1996 Act that it would, for the first time, allow the Bells to provide in-region, interLATA services pursuant to section 271, it required them to do so, for at least three years and as long as they retain market power, through a separate affiliate. *See* 47 U.S.C. § 272. And Congress also required each Bell carefully to account for transactions between the Bell and its affiliates used to offer those services – and directed the Commission to take an active role in monitoring those transactions and the Bells' compliance with those rules. *See id.* § 272(c)(b)(2), (5); § 272(d). As these provisions of the Act make clear, the Commission's affiliate transaction rules are not in the least bit outdated, as the Bells claim. And in all events, the recommendations of the Joint Conference are intended precisely to update the affiliate transaction rules by capitalizing on the experiences that regulators have had in implementing them over the past several years.

### E. Because Of The Bells' Market Power, Congress Placed More Stringent Obligations On The Bells And Other Local Incumbent Carriers, And The Commission Is Also Undoubtedly Permitted To Do So.

The Bells complain that the Commission should not adopt any regulatory accounting or reporting requirement that applies only to the BOCs or only to incumbent local carriers. *See, e.g.*, BellSouth at 13; *id.* at 3-4; *id.* at 6-8. According to the Bells, it makes no sense to adopt reporting requirements that do not apply evenly to all telecommunications carriers, because the Commission will not then obtain accurate information about the entire industry. The problem with the Bells' argument is that it assumes the Commission is limited to gathering data about the industry as a whole, when in fact, as discussed above, the Commission is also charged with monitoring dominant carriers with market power and ensuring that they do not abuse that market power. The Commission can gather more detailed information about such carriers than it does for nondominant carriers because the Commission has special obligations to monitor and regulate them. For this reason, the Commission has always and consistently drawn fundamental distinctions, for reporting requirements and otherwise, between dominant and nondominant carriers, as well as between large incumbent LECs and smaller incumbent LECs.

Although the Commission has in the past acted lawfully in drawing such distinctions,[25] the point is confirmed again by Congress' decisions in the 1996 Act to draw many of the same distinctions. Thus, Congress expressly placed a series of escalating obligations in section 251, with the fewest duties placed upon the general category of "telecommunications carriers," 47 U.S.C. § 251(a), an increasing amount on "local exchange carriers," *id.* § 251(b), and the full panoply of obligations on "incumbent local exchange carriers" (*id.* § 251(c)). And Congress also legitimately set forth specific obligations that applied only to the Bells, *see id*. §§ 271-76, and the courts of appeals have found that such "differential treatment" of the Bells is "quite understandable" because the Bells "enjoy a materially greater opportunity to shift costs from their [competitive] pursuits to their rate-regulated local exchange ventures." *BellSouth* v. *FCC*, 144 F.3d 58, 67 (D.C. Cir. 1998); *see also BellSouth* v. *FCC*, 162 F.3d 678, 689 (D.C. Cir. 1999) ("requiring the BOCs to comply with § 271 is not punitive, but, rather, legitimately based on the infrastructure they control," particularly the fact that they "provide over 80% of local telephone

[25] Indeed, BellSouth contradicts its own claims in arguing that the Commission has authority under § 220(h) to "prescribe different requirements" for carriers' accounts "for different classes of carriers." BellSouth at 2-3 & n.6. It is hard to see how the Commission would not be justified in establishing more rigorous regulatory accounting and reporting requirements for the Bells or for dominant incumbent local carriers.

service in the United States"). In these circumstances, there is no merit to the Bells' claims that the Commission should not endorse the Joint Conference's recommendations to strengthen reporting requirements for the Bells and for other dominant local carriers.

## CONCLUSION

For the foregoing reasons, the Commission should retain and extend its regulatory accounting requirements as recommended by the Joint Conference.

Respectfully submitted,

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**CERTIFICATE OF SERVICE**

I hereby certify that on this 17th day of February, 2004, I caused true and correct copies of the forgoing Reply Comments of AT&T Corp. to be served on all parties by mailing, postage prepaid to their addresses listed on the attached service list.

Dated: February 17, 2004
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